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The Petroleum Incentives Program

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The Petroleum Incentives Program

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Preface

The Minister of Energy, Mines and Resources stated in the opening pages of the National Energy Program (NEP) that two of the objectives of the NEP were to

establish the basis for Canadians to seize control of their own energy future through security of supply and ultimate independence from the world oil market; and

offer to Canadians, all Canadians, the real opportunity to participate in the energy industry in general and the petroleum industry in particular, and to share in the benefits of industry expansion.

The primary purpose of the Petroleum Incentives Program (PIP) is to help meet these objectives of energy security and Canadian ownership and control.

To date, the major federal incentives for oil and gas exploration and development have been provided through the income tax system. The Petroleum Incentives Program represents an attempt to move away from this tax-based incentives system, which was only of benefit to firms in a taxable position, to one which delivers grants to firms directly. It is expected that the program will help maintain and, indeed, accelerate the pace of exploration and development activity in Canada.

The NEP also stated that the Government of Canada is committed to the goal of

at least 50 percent Canadian ownership of oil and gas production by 1990, and Canadian control of a significant number of the larger oil and gas firms.

The PIP helps meet these objectives of Canadian ownership and Canadian control while still maintaining an attractive investment environment for foreign-owned firms. The program provides incentive payments to those applicants who are Canadian controlled and have a Canadian Ownership Rate (COR) of 50 percent or over. The incentive levels increase as the COR levels increase. In the Canada Lands, a Crown Share Incentive is available to all companies. This incentive, amounting to 25 percent of eligible exploration expenditures, assists the exploration effort while providing a share of such expenditures commensurate with the Government's retained interest in the Canada Lands.

The concept of PIP is clear. Canadians who carry out oil and gas exploration and development are entitled to receive cash payments of between 10 percent and 80 percent of their expenditures. This assists recipients to maintain the oil and gas lands (leases, etc.) they already hold and to acquire additional interests in new properties, thus achieving over time an increased beneficial interest by Canadians in oil

and gas production in Canada. At present non-Canadians receive 70 percent and control 80 percent of all production revenue. PIP is intended to increase substantially the share received and controlled by Canadians, and achieves this through the incentives it provides to Canadians active in the private sector.

The basic approach is simple since the program has been designed to be self-assessing. That is, an applicant for a PIP payment completes a form containing a series of steps leading to a determination of the cash amount due.

PIP does not seek to assess the nature or quality of the exploration or development work undertaken, nor is the entitlement to a payment in any way dependent on the results obtained.

However, large sums of money covering several thousand applications per year will be involved. Therefore, it has been necessary to design and develop a delivery system to handle the workload involved in an organized and disciplined manner, while keeping processing time to a minimum. A self-assessing system can work effectively only where definitions and rules are fully and clearly stated. In general, the definitions of costs and expenses which are eligible for PIP incentives follow Income Tax Act definitions of expenditures that are eligible for earned depletion allowance.

This paper is intended to provide information on PIP in sufficient detail to allow those who are planning to make exploration or development expenditures to determine, with a degree of accuracy for management decision purposes, the benefits they may receive. All expenditures as defined herein made on or after January 1, 1981 will be eligible for PIP incentives. However, application and payment must await Parliamentary approval of the necessary enabling legislation. Thus the PIP scheme set out in this paper is subject to modification.

While it is considered that PIP will contribute in a significant and substantial manner to an increase in the beneficial ownership and control by Canadians of the producing sector of the oil and gas industry, this Canadianization process may be capable of enhancement under the following circumstances. A Canadian entity or entities may be able to enter into an arrangement to earn an interest in the oil and gas rights of a non-Canadian in return for making expenditures in exploration and development, resulting in the entitlement to PIP incentives of \$100 million per year or more. In this case prior approval must be obtained, and in general will be given, where the non-Canadian entity agrees to increase its Canadian ownership to 50 percent or more and to become Canadian controlled.

Exploration and development are undertaken by a number of different entities, e.g., corporations, partnerships, joint exploration corporations, joint ventures, etc., and rules have been developed covering their eligibility as applicants for PIP incentives. However, many of these entities are created for tax purposes without the intent of creating long-term and viable exploration and development enterprises.

The purpose of PIP is to provide support for Canadian owned and controlled firms so that they may grow and play a more dominant role in the future in Canada's oil and gas sector. There is concern that entities may now be created with the primary objective of obtaining PIP incentives for firms which would not otherwise be eligible and in a manner which will not create viable Canadian-controlled firms in the long run. If this does occur, it may be necessary to introduce additional modifications to discourage such decisions.

A major challenge associated with the design of PIP has been the recognition that the benefits conferred by PIP on Canadians could in a variety of ways be transferred to non-Canadians. This concern has been examined in depth and it has been concluded that the normal workings of the marketplace would not discourage this tendency to a sufficient degree. This has led to the conclusion that rules are required to reduce such transfers to a minimum. The rules do not prohibit arrangements when transfer of benefits is judged to occur, but rather reduce PIP benefits in proportion to the transfer. While it is considered that a solution to the challenge has been found, it does add a complicating factor to the PIP system. These rules still allow the self-assessing process to be applied and should be readily understood by those familiar with the terms and conditions commonly found in the wide range of industry agreements in use. In fact, as far as possible, the total PIP scheme has been designed to be consistent with industry practice and approach.

Often it has been necessary to strike what is regarded as a reasonable compromise between a strict system and the practical realities and complexities that have over many years become established within the industry. A flexible approach is important, especially in the case of a new program, and it is recognized that experience may demonstrate some rules inhibit normal activity, whereas others may be too lax. PIP has been designed in such a way that reasonable modification may be made over time to resolve such problems.

This paper incorporates adjustments and modifications to the PIP system resulting from comments and suggestions received from petroleum industry associations, financial associations, companies and individuals in response to an earlier paper published December 19, 1980, entitled "Petroleum Incentives Program, The Basic Rules - A Framework".

For those familiar with the earlier paper, a summary of the main modifications will be found in the Appendix.

No further significant changes are anticipated at this time. However, PIP staff is ready to discuss specific questions, problems or situations with potential applicants and is prepared to provide detailed responses to the extent possible at this time.

1. SUMMARY

Eligible applicants who incur eligible expenses on oil and gas exploration and development in Canada or who incur eligible costs in the purchase of certain assets may obtain Petroleum Incentives Program (PIP) incentives by applying to the Petroleum Incentives Board (PIB). PIP incentives are a percentage of these eligible costs or expenses. The exact percentage depends on:

- (a) the Canadian Ownership Rate (COR) of the applicant;
- (b) the Canadian-control status of the applicant;
- (c) the location of the expenditure (i.e., Canada Lands or provincial lands);
- (d) the type of expenditure (i.e., exploration, development or eligible assets); and
- (e) the year in which the expenditures are incurred.

This information is summarized in Tables 1 and 2 of the paper (Section 2.1).

Individuals, corporations, partnerships and trustees are eligible applicants for PIP incentives. As a general rule, persons who are tax-exempt under Section 149 of the Income Tax Act at the time the eligible expenses are incurred are eligible for only the 25-percent Crown Share Incentive on Canada Lands (Section 3).

An applicant follows four steps in determining the amount of his PIP incentive:

- Calculate the amount of eligible costs or expenses;
- Adjust the eligible costs or expenses by the appropriate adjustment factors;
- Determine the appropriate PIP rate; and
- Multiply the adjusted eligible costs or expenses by the appropriate PIP rate.

Calculate the Amount of Eligible Costs and Expenses

For the purpose of the Petroleum Incentives Program, eligible expenditures fall into three categories:

Eligible Exploration Expenses,
Eligible Development Expenses, and
Eligible Asset Costs.

In general, expenditures are Eligible Exploration Expenses and Eligible Development Expenses if they are Canadian exploration expenses or Canadian development expenses under the Income Tax Act. However,

"Canadian exploration and development overhead expense", as defined in the Income Tax Act Regulations, is not included as eligible expenses.

Eligible Asset Costs generally include capital costs incurred in the construction or improvement of an oil sands facility, heavy oil upgrading facility, or tertiary oil recovery project located in Canada, if the facility or project has been approved by the Minister of Energy, Mines and Resources, and if the assets are eligible for earned depletion allowance (Section 4).

Adjust Eligible Costs and Expenses

PIP provides cash incentives to individuals and businesses to encourage them to explore and develop new sources of oil and gas in Canada, and to invest in oil sands projects, heavy oil upgrading facilities, or tertiary oil recovery projects. PIP incentives are structured to provide entities which are Canadian controlled and which have a COR of 50 percent or more (high COR) with a higher level of incentive than entities which are not Canadian controlled or which have a COR of less than 50 percent (low COR).

A major challenge associated with the design of PIP has been the recognition that the benefits conferred by PIP on Canadians could in a variety of ways be transferred to non-Canadians. This issue has been examined in depth and it has been concluded that the normal workings of the marketplace would not discourage this tendency to a sufficient degree. This has led to the conclusion that rules are required to reduce such transfers to a minimum.

There are two steps in adjusting eligible costs and expenses. First, any expenses incurred by the applicant as earning expenses for the farmer's land acquisition or land maintenance costs are deducted dollar for dollar from the applicant's eligible expenses (Section 5.10). Second, the eligible expenses are adjusted by the application of the adjustment factors. These adjustment factors govern the size of the working interest to be earned relative to expenses incurred in a farm-in situation, the size of working interest relative to expenses in situations where the working interest has already been earned, and the area of land in which the working interest will be earned (Section 5).

This process is best demonstrated by reference to the basic farm-in formula.

$$\begin{array}{l} \text{Adjusted} \\ \text{Eligible} \\ \text{Expenses} \end{array} = \begin{array}{l} \text{Eligible} \\ \text{Expenses} \end{array} \times \frac{2 \times \text{Net-Working-Interest Percentage}}{\text{Expense Percentage}}$$

$$\times \frac{\text{Net-Working-Interest Land Area}}{\text{Minimum Land Block}}$$

$$A = E \times \frac{2 \times \text{NWIP}}{\text{EP}} \times \frac{\text{NWILA}}{\text{MLB}}$$

The method of determining eligible expenses is described in Section 4 of the paper. The calculation of the net-working-interest percentage is described in Section 5.2, and the factors associated with transfers of benefits through land block size are described in Section 5.5.

It should be noted, however, that these adjustments do not have to be applied in all situations, and in the situations where they do not apply, the applicant may apply for PIP incentives without adjustment of his eligible expenses. For example, if

- (a) the expense is incurred pursuant to a written agreement entered into on or before October 28, 1980; or
- (b) in the case of provincial lands, all other working-interest owners in the land to which the expense pertains have a COR of 50 percent or more and are Canadian controlled; or
- (c) in the case of Canada Lands, all other working-interest owners in the land to which the expense pertains have a COR at the same level or higher and are Canadian controlled,

the adjustment rules need not be applied, and the applicant may apply for PIP incentives on his eligible expenses, rather than on his adjusted eligible expenses (Section 5.8).

Calculation of PIP Rate

The next step is to determine the appropriate PIP rate by referring to Tables 1 and 2 (Section 2.1).

Calculation of Incentive

The final step is to multiply the adjusted eligible expense by the appropriate PIP rate to determine the size of the incentive.

2. LEVEL OF INCENTIVES AND COR-RELATED ISSUES

2.1 Level of Incentives

PIP payments are a percentage of eligible expenditures on exploration and development in Canada and a percentage of eligible expenditures on certain assets. The exact percentage depends on

- (a) the Canadian Ownership Rate (COR) of the applicant;
- (b) the Canadian-control status of the applicant;
- (c) the location of the expenditure (i.e., on Canada Lands or provincial lands);
- (d) the type of expenditure (i.e., exploration, development or eligible assets); and
- (e) the year in which the expenditures are incurred.

This information, which was announced by the Minister of Energy, Mines and Resources on February 16, 1981, is summarized in Tables 1 and 2.

The incentive payment of 25 percent of eligible exploration expenses on Canada Lands (the "Crown Share Incentive"), available to any investor, reflects an understanding on the part of the Government that in return for its direct participation in the industry's efforts whenever they occur in the Canada Lands, there should be a commensurate Government contribution to the costs of that activity.

An applicant follows four steps in determining the amount of his PIP incentive.

- . Calculate the amount of eligible costs or expenses.
- . Adjust the eligible costs or expenses by the appropriate adjustment factor, if any.
- . Determine the appropriate PIP rate from Tables 1 and 2.
- . Multiply the adjusted eligible costs or expenses by the appropriate PIP rate.

Table 1. Transition Period for Phasing in Incentive Payments

		<u>COR Level of Applicants</u>			
		<u>Level 1*</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Level 4</u>
		<u>%</u>	<u>%</u>	<u>%</u>	<u>%</u>
1981	less than 50	50 or more	60 or more	65 or more	
1982	50	50	61	67	
1983	50	50	62	69	
1984	50	50	63	71	
1985	50	50	64	73	
1986 and later	50	50	65	75	

* Level 1 refers to applicants who have CORs of less than 50 percent or who are not Canadian controlled.

Table 2. Percentage Levels of Incentive Payments for Oil and Gas Exploration and Development.

	<u>Provincial Lands</u>				<u>Canada Lands</u>			
	Level				Level			
	1	2	3	4	1	2	3	4
	%	%	%	%	%	%	%	%
<u>Exploration</u>								
1981	nil	nil	25	35	25*	35**	65**	80**
1982	nil	10	25	35	25	45	65	80
1983	nil	10	25	35	25	45	65	80
1984	nil	15	25	35	25	50	65	80
1985	nil	15	25	35	25	50	65	80
1986	nil	15	25	35	25	50	65	80
<u>Development</u>								
1981	nil	nil	15	20	nil	nil	15	20
1982	nil	10	15	20	nil	10	15	20
1983	nil	10	15	20	nil	10	15	20
1984	nil	10	15	20	nil	10	15	20
1985	nil	10	15	20	nil	10	15	20
1986	nil	10	15	20	nil	10	15	20
<u>Asset Costs</u>								
1981	nil	nil	15	20	nil	nil	15	20
1982	nil	10	15	20	nil	10	15	20
1983	nil	10	15	20	nil	10	15	20
1984	nil	10	15	20	nil	10	15	20
1985	nil	10	15	20	nil	10	15	20
1986	nil	10	15	20	nil	10	15	20

* The 25-percent Crown Share Incentive

** Includes the 25-percent Crown Share Incentive available to all investors.

Example;

Assume that an applicant incurs \$1 million of eligible exploration expenses on provincial lands in 1981. Furthermore, assume that the adjustment factors do not reduce the amount of his eligible expenses. Finally, assume that the applicant is Canadian controlled and has a COR of 63 percent.

- Calculate the size of eligible expenses.

\$1 million.

- Adjust the eligible expenses, if necessary.

\$1 million.

- Determine the appropriate PIP rate from Tables 1 and 2.

The applicant has a level 3 COR, is Canadian controlled, and incurred the expenses for exploration on provincial lands in 1981. Therefore, the appropriate PIP rate is 25 percent.

- Multiply the adjusted eligible expenses by the appropriate PIP rate.

$$\begin{aligned} \text{PIP Incentive} &= \begin{array}{c} \text{Adjusted} \\ \text{Eligible} \\ \text{Expenses} \end{array} \times \begin{array}{c} \text{PIP} \\ \text{Rate} \end{array} \\ &= \$1,000,000 \times 25\% \\ &= \$250,000 \end{aligned}$$

The applicant may obtain a PIP incentive of \$250,000.

2.2 Grace Periods

A grace period exists to provide a reasonable time during which a corporation can effect a change in its COR level.

The PIP rate depends on the level of Canadian ownership and the Canadian-control status, as determined by the Petroleum Monitoring Agency (PMA). If a decrease in the COR of an applicant occurs as the result of a transaction or series of transactions in which the applicant did not directly or indirectly participate and which he could not directly or indirectly control and the change in COR places the applicant in a lower COR level, the applicant is entitled to PIP incentives at the level prior to the COR change for a period of six months.

During this initial six months, on application to the Petroleum Incentives Board, the Minister on a discretionary basis may extend the grace period for an additional six months. If the Minister does grant this six-month extension, the applicant receives incentives during the second six months at the lower-level rate until such time as he obtains a new COR certificate which indicates that he has regained his old COR level. Incentives are paid on the basis of the new higher-level incentive rate as of the effective date of a new COR certificate indicating that the applicant has regained his original COR level. A cheque will also be issued to the applicant to cover the difference between what the applicant would have received had he been paid at the higher level and what he did receive because he had been paid at the lower level.

2.3 Transitional COR Determination

Once the COR and PIP legislation is enacted, the Minister will have the authority during a transitional period to accept the calculation submitted by the applicant to the PMA as evidence of an applicant's COR level and Canadian-control status. This authority will permit timely processing of PIP applications at the outset of the program. In this way, a PIP application can be processed and payment made before a COR certificate is issued by the PMA. The rules provide that when the certificate is issued by the PMA, the certificate supersedes the applicant's calculation accepted by the Minister. If a PIP incentive was paid on the basis of a higher COR than the COR subsequently determined by the PMA, an overpayment is deemed to have been made, and recovery action triggered.

3. ELIGIBLE APPLICANTS

3.1 General

Individuals, corporations, partnerships and trustees, administrators or other legal representatives of trust property may apply for PIP incentives.

With the exceptions noted below, persons who are tax-exempt under Section 149 of the Income Tax Act at the time the eligible expenses are incurred are not eligible for PIP incentives in respect of such expenses, other than the Crown Share Incentive on Canada Lands. To the extent that pension trusts, pension corporations, and certain deferred income plans (employees' profit-sharing plans, supplementary unemployment benefit plans, registered retirement savings plans, deferred profit-sharing plans, registered education savings plans, registered retirement income funds) are permitted to participate directly or indirectly in the oil and gas business, they are eligible for PIP incentives.

Corporations which are controlled directly or indirectly by the Crown are not eligible applicants unless they have given a satisfactory undertaking that they do not intend to become tax-exempt. Crown corporations listed in Schedule D to the Financial Administration Act are eligible applicants.

The COR of eligible applicants is reduced for PIP purposes by the number of percentage points of these applicants that are attributable to ineligible persons, i.e., persons identified in the two preceding paragraphs. Therefore, the participation or investment by ineligible persons in such applicants may reduce the incentives payable to them.

3.2 Flow-Through Shares

When the Canadian exploration expense (CEE) and Canadian development expense (CDE) are incurred by investors solely in consideration for shares of the capital stock of a corporation, the investors are entitled to PIP incentives. The corporation will act for the investors in filing the application and receiving the incentives.

The relevant COR is that of the corporation issuing the shares. In measuring the COR of the corporation, the shares to be issued to the investors pursuant to the flow-through-share transaction are taken into account where:

- (a) the COR would be higher if the shares were issued than if they were not issued and where it is reasonable to presume the shares will be issued within 24 months of the date of the agreement, and
- (b) the COR would be lower if the shares were issued than if they were not issued.

However, shares issued by the corporation, which are not convertible into common shares, do not participate in profits beyond a fixed dividend rate, are not redeemable at a rate beyond their par value or redemption value and do not permit the shareholders to participate to a disproportionate extent in the future revenues of the corporation are not taken into account except to reduce the COR if they have been issued for the purpose of circumventing the purpose and intent of the rules respecting measurement of Canadian ownership rate or determination of control. For details of COR measurement, reference should be made to the paper entitled, "Method for Measurement of Canadian Ownership and Determination of Control under the National Energy Program", published by the Petroleum Monitoring Agency (PMA) on April 22, 1981.

3.3 Joint Exploration Corporations

A joint exploration corporation within the meaning of paragraph 66(15)(g) of the Income Tax Act is treated in the same manner as any other corporation for the purpose of PIP incentives. In other words, the joint exploration corporation is the applicant and entitled to incentives in its own right.

3.4 Partnerships

As a general rule, the partnership is the applicant for PIP incentives. The Minister has discretion to allow individual partners within partnerships comprised of 12 or fewer partners to be eligible applicants. The discretion, however, will be exercised only in limited circumstances.

The PIP rules generally treat the partnership as responsible for expenditures on a prospect and as earning or owning an interest in a prospect. In order to treat individual partners as applicants, it is necessary to determine each partner's share of costs and working interest.

There are numerous factors which may affect the determination of a partner's working interest, e.g., the partner's share in income or capital, and variations in the partner's distribution entitlement before and after well payout and before and upon dissolution of the partnership. Similarly, there are various factors which may affect the determination of a partner's expense percentage, e.g., the partner's share of costs before and after well payout, and the manner and extent to which partnership costs are financed by bank loans.

If the partnership arrangement is such that the working-interest percentage, expense percentage and other components of the adjustment formulae can be readily attributed to the partners, the Minister may exercise his discretion in allowing the partners to be treated as individual applicants.

3.5 Requisite Interests

An applicant must establish that he has or is entitled to earn a working interest in the lands in respect of which the eligible exploration or development expenses are incurred. An exception to this rule is the Crown Share Incentive for Canada Lands. Further exceptions are set forth in Section 5.8.

A similar rule applies in the case of asset costs eligible for PIP, i.e., it is necessary for the applicant to demonstrate that he has an operating interest in the asset in respect of which the eligible asset costs are incurred. An operating interest in relation to oil sands projects and heavy oil upgraders includes an interest in the assets comprising the facilities and a commensurate interest in the rights, benefits and revenues obtained from the operation and management of the facilities. An operating interest in relation to a tertiary oil recovery project includes an interest in the equipment and a commensurate interest in the oil and gas recovered through the operation of the project. A working interest in the lands to which the tertiary oil recovery project pertains is also required. A lessor's interest in eligible assets is not an operating interest.

4. ELIGIBLE COSTS AND EXPENSES

4.1 General

For the purpose of the Petroleum Incentives Program, eligible expenditures fall into three categories:

Eligible Exploration Expenses,
Eligible Development Expenses, and
Eligible Asset Costs.

In general, expenses are Eligible Exploration Expenses and Eligible Development Expenses if they fall within the definitions of Canadian exploration expense or Canadian development expense in the Income Tax Act. However, expenses in respect of a mineral resource as defined in the Income Tax Act, other than a bituminous sands deposit, oil sands deposit or oil shale deposit, do not qualify as Eligible Exploration Expenses or Eligible Development Expenses.

In general, Eligible Asset Costs include capital costs incurred in the construction or improvement of an oil sands facility, a heavy oil upgrader or a tertiary oil recovery project located in Canada, if the facility or project has been approved by the Minister of Energy, Mines and Resources, and if the assets are eligible to earn depletion under the Income Tax Act.

Eligible Asset Costs do not include any cost incurred in respect of petroleum rights, rights in relation to the surface of land or in respect of an asset which has previously been used for any purpose.

The time at which costs and expenses are incurred are governed by the following rules: In relation to services, the expenses are deemed to be incurred when the services are rendered. In relation to assets, the costs or expenses are deemed to be incurred when the assets are acquired.

The following costs or expenses are not eligible for PIP incentives:

- (a) any cost or expense incurred by an applicant to reimburse a person for a cost or expense initially incurred by that person, unless the cost or expense was initially incurred by that person on the applicant's behalf;
- (b) any cost or expense in respect of which the person incurring the cost or expense has been or will be repaid;
- (c) any cost or expense to the extent the person incurring the cost or expense has received or is entitled to receive assistance or benefit from a government, municipality or other public authority;
- (d) any expense which constitutes a "Canadian exploration and development overhead expense" as defined in the Income Tax Regulations;

- (e) any cost incurred in respect of any asset which, if it were an expense incurred in respect of exploration or development, would constitute a "Canadian exploration and development overhead expense";
- (f) any cost or expense to the extent that it is not reasonable in the circumstances;
- (g) any cost or expense that unduly or artificially increases the amount of an incentive under the Petroleum Incentives Program.

4.2 Netting Out of Assistance or Benefit

Any assistance or benefit received or entitled to be received from a government, municipality or other public authority in respect of an eligible cost or expense within five years of incurring the eligible cost or expense reduces the amount of the cost or expense eligible for PIP incentives. Such assistance or benefit includes a grant, subsidy, forgivable loan, deduction from royalty, tax and investment allowance.

The time when an assistance or benefit is received or entitled to be received is determined on a basis consistent with the Income Tax Act.

When the assistance or benefit is received or entitled to be received before application for an incentive in respect of the eligible cost or expense giving rise to the assistance or benefit, the amount of the assistance or benefit reduces the eligible amount of that cost or expense.

When the assistance or benefit is received or entitled to be received after application for an incentive in respect of the eligible cost or expense giving rise to the assistance or benefit, the reduction is made by one or the other of the following two methods, as the applicant may select.

First, the assistance or benefit received or entitled to be received may reduce the eligible amount of the cost or expense giving rise to the assistance or benefit. This method of reduction requires the recalculation of the eligible amount of the cost or expense, the recalculation of all adjustment factors (see Section 5), and a determination of the amount of the incentive paid to the applicant in excess of the amount to which he is actually entitled.

Second, to the extent the applicant has incurred other eligible costs or expenses for which an incentive has not yet been applied, the assistance or benefit received or entitled to be received may reduce those eligible costs or expenses. This method of reduction requires the assistance or benefit to be deducted from the applicant's adjusted eligible costs or expenses remaining after application of the adjustment factors.

When eligible exploration expenses give rise to the assistance or benefit, the assistance or benefit must be deducted from adjusted eligible exploration expenses. When the cost or expense that gave rise to the assistance or benefit is not identifiable by the applicant, the

expense is treated for these purposes as an eligible exploration expense. Any assistance or benefit received or entitled to be received in a year and attributable to a class of costs or expenses is treated on a "first-in, first-out" basis. For instance, if an applicant has received any assistance or benefit during a year in respect of both pre-1981 and post-1980 expenditures, the assistance or benefit received is considered to relate to the pre-1981 expenditures in the first instance, and to this extent does not reduce the post-1980 expenditures eligible for PIP incentives.

4.3 Eligible Geological Geophysical or Geochemical Expenditures

Expenditures on certain Canadian geological, geophysical or geochemical activities are eligible for PIP incentives.

The applicant may apply for PIP incentives on geological, geophysical or geochemical activities to the extent that the expenses incurred qualify as a Canadian exploration expense (CEE). Incentives are paid only on activities where the date of commencement of data acquisition is after December 31, 1980.

On Canada Lands, geological, geophysical or geochemical activities must be authorized pursuant to the Oil and Gas Production and Conservation Act (to be amended by the Canada Oil and Gas Act).

On provincial lands, geological, geophysical or geochemical activities must be authorized pursuant to any applicable provincial regulations governing such activities.

The following persons may apply for PIP incentives on geological, geophysical or geochemical expenses:

- (a) the person incurring the expense, if he conducts the activities for his own exploration purposes;
- (b) the person (including a group of persons) on whose behalf the geological, geophysical or geochemical activities have been conducted; or
- (c) the first person or group who purchases the surveys, maps or interpretive data.

Incentives are paid only once on any geological, geophysical or geochemical activity and are paid to the first qualified applicant. An applicant referred to in (c) above must obtain certification from the vendor that he is the first purchaser.

Incentives paid to the producer of the survey, maps or interpretive data or the person on whose behalf the activities are conducted are based on actual cost. Incentives paid to the first purchaser are based on purchase price.

Incentives are paid only on surveys, maps or interpretive data which are not in the public domain at the time the expense is incurred.

Expenditures for reprocessing and interpretation of geophysical data qualify for incentives to the extent that such expenditures qualify for CEE.

4.4 Prior Approval of Large Projects

For certain large projects, the prior approval of the Minister of Energy, Mines and Resources is required.

If one or more entities which have CORs of 50 percent or more and are Canadian controlled, as participants in a farm-out transaction or series of transactions involving one or more entities as farmors, any one of whom has a COR of less than 50 percent or is foreign controlled, incur costs or expenses in a calendar year which could foreseeably result in \$100 million or more of PIP incentives, whether or not the incentives are claimed in that year, the costs and expenses are not eligible for PIP incentives, unless the farm-out proposal has received the prior approval of the Minister.

In general, approval of large projects will be given when the foreign-controlled entities agree to a program to raise their Canadian ownership to 50 percent or more and to become Canadian controlled. The Minister has relieving discretion in the application of this rule.

The rule does not apply to the Crown Share Incentive. Projected payments of such incentives are, however, included in the determination of whether the rule applies (i.e., whether \$100 million in total PIP incentives are anticipated to be made in a year).

5. ADJUSTED ELIGIBLE EXPENSES

5.1 General

PIP provides cash incentives to individuals and businesses to encourage them to explore and develop new sources of oil and gas in Canada, and to invest in oil sands projects, heavy oil upgraders and tertiary recovery equipment. PIP incentives are structured to provide entities which are Canadian controlled and which have a COR of 50 percent or more (high-COR) with a higher level of incentive than entities which are not Canadian controlled or which have a COR of less than 50 percent (low-COR).

Given the graduated system of incentives, low-COR entities that hold land could enter into arrangements with high-COR entities that would permit them to access the high-COR incentive rates, but without transferring a commensurate economic benefit to the high-COR entity. This type of arrangement would be counter to the purpose of PIP, and it has been decided to institute rules to prevent abuse of the program. These rules cover:

- the size of working interest to be earned relative to expenses incurred in a farm-in situation;
- the size of working interest relative to expenses in a straight-up situation;
- the size of production penalties or working-interest penalties;
- the area of land in which the working interest is earned or is held;
- the amount of work that is eligible for incentives on a given area of land; and
- expenditures not eligible for incentives.

In certain circumstances the adjustment rules need not be applied and the applicant may apply for PIP incentives on his eligible expenses rather than his adjusted eligible expenses. These adjustments do not apply to the Crown Share Incentive. Other circumstances where these rules need not be applied are described later in this paper.

The Minister has relieving discretion in the application of the adjustment factors. This flows from the recognition that the adjustment formulae are general rules which may work a hardship in individual cases.

5.2 Net-Working-Interest Percentage

In this section:

- "GI" is the gross interest (an interest in petroleum including a gross-overriding royalty, a production payment, or excess freehold lessor's royalty, but excluding a working interest or a net interest);
- "NI" is the net interest (an interest in petroleum after first deducting all costs incurred in recovering the petroleum);
- "PC" is the percentage of petroleum upon which the net interest or gross interest is calculated;
- "PP" is the percentage of petroleum out of which the net interest or gross interest is paid;
- "RF" is the reduction factor related to the net interest or gross interest.

The net-working-interest percentage of a person is a measure of his economic interest in the oil and gas production from the land to which the net working interest pertains. The net-working-interest percentage is the percentage obtained when the "working interest" is multiplied by the "adjustment factor".

5.2.1 Working Interest

A working interest is an undivided interest in oil or gas rights.

The working interest of an applicant for the purposes of the adjustments is the lowest working interest of the applicant in the land to which the net-working interest pertains. In a farm-in situation where a working interest is to be earned, the working interest is deemed to have been earned for the purpose of calculating the net-working-interest percentage. Any obligation which is in existence when the expenditures are incurred to dispose of all or part of a working interest is deemed to have been carried out when calculating the working interest. The one exception to this general rule is the proposed right of the Crown to obtain a working interest in Canada Lands pursuant to the Canada Oil and Gas Bill. This Crown right need not be taken into account until it is exercised.

When a working interest excludes either oil or gas, or excludes production from certain areas or stratigraphic formations, the working interest is zero. This rule does not apply, however, when:

- (a) the substances or formations were retained from the working interest by Her Majesty or a freehold owner of petroleum substances;

- (b) the formations were proven to be capable of production in commercial quantities prior to the working interest being acquired; or
- (c) the formations were below the depth to which an oil or gas well was drilled to earn the working interest or a previous working interest from which the working interest was derived unless the well is drilled to 4,000 metres or more on Canada Lands.

5.2.2 Adjustment Factor

The adjustment factor is the percentage remaining after all the reduction factors are subtracted from 100 percent. The reduction factors relate to net interests and gross interests, except when:

- (a) the interest was created on or before October 28, 1980;
- (b) in the case of provincial lands, the beneficial owner of the gross or net interest has a COR of 50 percent or more and is Canadian controlled;
- (c) in the case of Canada Lands, the beneficial owner of the gross or net interest is Canadian controlled and has a COR level equal to or greater than that of the applicant; or
- (d) the COR of the applicant is reduced by the gross or net interest.

5.2.2.1 Net Interest

If the net interest is a fixed percentage and is calculated upon and payable out of all production, the reduction factor is the fixed percentage.

If the net interest is a range of rates which does not exceed some fixed maximum percentage and is calculated upon and payable out of all production, the reduction factor is the maximum rate of the range.

If the net interest is payable out of less than all production on which it is calculated, the reduction factor is the product of the net interest and the percentage of production on which the net interest is calculated, divided by the percentage of production out of which the net interest is paid.

$$RF = NI \times \frac{PC}{PP}$$

When a net interest is convertible to a working interest, the net interest generally is deemed not to be a net interest. However, if the net-interest percentage exceeds the working-interest percentage into which it may be converted, the amount by which the net-interest percentage exceeds the working-interest percentage is treated as a net interest.

If the net interest is calculated in any other manner, the reduction factor is 100 percent.

5.2.2.2 Gross Interest

If the gross interest is a fixed percentage and is calculated upon and payable out of all production, the reduction factor is three times the fixed percentage.

If the gross interest is a range of rates which does not exceed some fixed maximum percentage and is calculated upon and payable out of all production, the reduction factor is three times the maximum rate of the range.

If the gross interest is payable out of less than all production on which it is calculated, the reduction factor is three times the product of the gross interest and the percentage of production on which the gross interest is calculated, divided by the percentage of production out of which the gross interest is paid.

$$RF = 3 \times GI \times \frac{PC}{PP}$$

When a gross interest is convertible to a working interest, the gross interest generally is deemed not to be a gross interest. However, if the gross-interest percentage exceeds one-third the working-interest percentage into which it may be converted, the amount by which the gross-interest percentage exceeds one-third the working-interest percentage is treated as a gross interest.

If the gross interest is calculated in any other manner, the reduction factor is 100 percent.

5.2.2.3 Lessor's Royalty

A lessor's royalty is not a gross interest when the lessor's royalty is calculated as an amount equal to the royalty that would be chargeable by Her Majesty under an equivalent Crown lease less any freehold mineral tax payable. When the royalty is calculated in any other manner, the royalty is a gross interest to the extent by which it exceeds 30 percent of production.

Three examples have been developed to demonstrate the calculation of the net-working-interest percentage.

Example 1:

Person A obtained the petroleum rights for an area of land in January 1981 giving a non-Canadian geologist a one-percent net-profits interest on all production. Applicant B farmed in on A for a 50-percent working interest on the property, subject to the net interest. Applicant B then farmed out to C a 20-percent working interest, again subject to the net interest.

Step 1 - Calculation of Working Interest

Working interest acquired by B from A	50%
Working interest disposed by B to C	<u>20%</u>
Working interest retained by B	30%

Step 2 - Calculation of Adjustment Factor

Adjustment Factor	=	100	-	Sum of Reduction Factors	
Reduction factor due to one-percent net interest created after October 28, 1980 and beneficially held by a non-Canadian.					1%
Adjustment Factor	=	100	-	1	
	=	99			

Step 3 - Calculation of Net-Working-Interest Percentage

Net-Working- Interest Percentage	=	Working Interest	x	Adjustment Factor	
	=	30%	x	99%	
	=	29.7%			

The net-working-interest percentage of applicant B is 29.7.

Example 2:

An applicant has a 40-percent working interest in the petroleum rights from an area of land. These rights are subject to a gross-overriding royalty of two percent calculated upon all production and paid out of all production. These rights were created in December 1980 and are beneficially held by an entity which is not Canadian controlled. The petroleum rights are also subject to a fixed freehold lessor's royalty of 35 percent of all production, also created in December 1980 and beneficially held by a non-Canadian. The freehold lessor's royalty is paid out of all production.

Step 1 - Calculation of Working Interest

Working interest	40%
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Step 2 - Calculation of Adjustment Factor

Adjustment Factor	=	100	-	Sum of Reduction Factors
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- (a) Reduction factor due to two-percent gross-overriding royalty created after October 28, 1980 and beneficially held by a non-Canadian.

$$\begin{aligned}\text{Reduction Factor} &= 3 \times \text{Gross Interest} \\ &= 3 \times 2\% \\ &= 6\%\end{aligned}$$

- (b) Reduction factor due to 35-percent freehold lessor's royalty created after October 28, 1980 and beneficially held by a non-Canadian.

Freehold royalty	35%
Freehold royalty ceiling	<u>30%</u>
Freehold royalty treated as gross interest	5%

$$\begin{aligned}\text{Reduction Factor} &= 3 \times \text{Gross Interest} \\ &= 3 \times 5\% \\ &= 15\%\end{aligned}$$

$$\begin{aligned}\text{Adjustment Factor} &= 100 - 6 - 15 \\ &= 79\end{aligned}$$

Step 3 - Calculation of Net-Working-Interest Percentage

$$\begin{aligned}\text{Net-Working-Interest Percentage} &= \text{Working Interest} \times \text{Adjustment Factor} \\ &= 40\% \times 79\% \\ &= 31.6\%\end{aligned}$$

The net-working-interest percentage of the applicant is 31.6.

Example 3:

Applicant J, a Canadian-controlled corporation, has a 60-percent working interest in certain lands. This working interest is subject to a two-percent gross-overriding royalty created in January 1981. This gross-overriding royalty is calculated on 80 percent of production and paid out of only the production attributable to the working interest of J. The holder of this gross interest is a non-Canadian.

Step 1 - Calculation of Working Interest

$$\text{Working interest} \qquad \qquad \qquad \underline{60\%}$$

Step 2 - Calculation of Adjustment Factor

Reduction factor due to gross-overriding royalty created after October 28, 1980 and beneficially held by a non-Canadian.

$$\begin{aligned}\text{Reduction Factor} &= 3 \times \text{GI} \times \frac{\text{PC}}{\text{PF}} \\ &= 3 \times 2 \times \frac{80}{60} \\ &= 8\end{aligned}$$

$$\begin{aligned}
 \text{Adjustment} & \\
 \text{Factor} & = 100 - \text{Sum of Reduction Factors} \\
 & = 100 - 8 \\
 & = 92
 \end{aligned}$$

Step 3 - Calculation of Net-Working-Interest Percentage

$$\begin{aligned}
 \text{Net-Working-Interest Percentage} & = \text{Working Interest} \times \text{Adjustment Factor} \\
 & = 60\% \times 92\% \\
 & = 55.2\%
 \end{aligned}$$

The net-working-interest percentage of the applicant is 55.2.

5.3 Definitions

In the following adjustment formulae:

- "A" is the amount of a class of eligible costs or expenses adjusted by the relevant formula;
- "C" is the amount of a class of eligible asset costs determined before adjustment by the relevant formula;
- "CP" is the cost percentage of the applicant in respect of a class of eligible asset costs;
- "E₁" is the amount of a class of eligible exploration or eligible development expenses which are incurred by the applicant, but which is not an E₂ expense, before adjustment by the relevant formula;
- "E₂" is the amount of a class of eligible exploration or development expenses incurred by the applicant by virtue of another working-interest owner having declined to incur such expenses before adjustment by the relevant formula;
- "EP" is the expense percentage of the applicant in respect of a class of eligible exploration expenses or eligible development expenses;
- "MLB" is the minimum land block in that part of Canada (see Section 5.5.1);

- "NWILA" is the net-working-interest land area (i.e., land in which the applicant owns a working interest that is used to satisfy the minimum land block requirement - see Section 5.5.1) in respect of a class of eligible exploration expenses or eligible development expenses;
- "NWIP" is the net-working-interest percentage of the applicant in respect of a net-working-interest land area (see Section 5.2);
- "OIP" is the operating-interest percentage (i.e., undivided percentage interest in an asset) of the applicant in respect of a class of eligible asset costs;
- "PLA" is the penalty land area (i.e., land in which an applicant acquires a working interest from another working-interest owner who does not incur eligible exploration expenses or eligible development expenses);
- "PNWIP" is the net-working-interest percentage of another working interest owner acquired by the applicant in respect of a penalty land area;
- "PPP" is the production-penalty percentage (i.e., the percentage of eligible exploration expenses or eligible development expenses incurred by the applicant, by virtue of another working-interest owner not incurring such expenses, which will be recovered by the applicant out of future production) acquired by the applicant in respect of a class of eligible exploration expenses or eligible development expenses;
- "TNWIP" is the net-working-interest percentage of another working-interest owner in respect of the penalty land area determined without reduction of the net-working-interest percentage acquired by the applicant or any other person incurring penalty costs;
- "TPE" is the total eligible exploration expenses or eligible development expenses incurred by the applicant and all other persons to acquire a working interest in the penalty land area from another working-interest owner.

The adjustment of eligible expenses must be made by grouping the eligible exploration expenses and eligible development expenses in relation to each well, and the eligible asset costs in relation to each oil sands facility, heavy oil upgrader or tertiary oil recovery project into separate classes of expenses. A class of expenses consists of those expenses in relation to a well, project or facility in respect of which the expense percentage, production-penalty percentage, or cost percentage is the same. For example, in respect of eligible exploration expenses to be adjusted by the following formula, a class of expenses consists of those expenses in respect of which the applicant's expense percentage is the same for all of the expenses.

$$A = E_1 \times \frac{2 \times NWIP}{EP} \times \frac{NWILA}{MLB}$$

5.4 Transfer Through Size of Net-Working-Interest Percentage

5.4.1 Farm-in

In situations in which the applicant's working interest is earned by incurring agreed expenses, the amount of expenses upon which PIP incentives are paid is adjusted downwards if the expense percentage of the applicant in respect of such expenses is greater than two times his net-working-interest percentage. The adjustment is made using the following formula.

$$\begin{array}{l} \text{Adjusted} \\ \text{Eligible} \\ \text{Expenses} \end{array} = \begin{array}{l} \text{Eligible} \\ \text{Expenses} \end{array} \times \frac{2 \times \text{Net-Working-Interest Percentage}}{\text{Expense Percentage}}$$

$$A = E_1 \times \frac{2 \times \text{NWIP}}{\text{EP}}$$

If $\frac{2 \times \text{NWIP}}{\text{EP}}$ is greater than 1, it is deemed to be 1.

Example 1: No Downward Adjustment of Eligible Expenses

An applicant earns a net-working interest of 25 percent by incurring 50 percent of total eligible expenses of \$200,000--i.e., the applicant has incurred \$100,000 of eligible expenses.

$$\begin{aligned} A &= E_1 \times \frac{2 \times \text{NWIP}}{\text{EP}} \\ &= 100,000 \times \frac{2 \times 25}{50} \\ &= 100,000 \end{aligned}$$

The appropriate PIP rate is applied to \$100,000 of adjusted eligible expenses to determine the amount of the PIP incentive.

Example 2: Some Downward Adjustment of Eligible Expenses

An applicant earns a net-working interest of 20 percent by incurring 50 percent of total eligible expenses of \$200,000--i.e., the applicant incurs \$100,000 of eligible expenses.

$$\begin{aligned} A &= E_1 \times \frac{2 \times \text{NWIP}}{\text{EP}} \\ &= 100,000 \times \frac{2 \times 20}{50} \\ &= 80,000 \end{aligned}$$

The appropriate PIP rate is applied to \$80,000 of adjusted eligible expenses to determine the amount of the PIP incentive.

5.4.2 Delineation

A different adjustment rule applies when eligible expenses are incurred in drilling or completing a well in Canada Lands when the well is drilled for the purpose of delineating or determining the extent or quality of an accumulation of oil or gas, and the drilling of the well commenced before commercial production from the accumulation. In these circumstances, eligible expenses are adjusted downwards if the expense percentage of the applicant is greater than ten times his net-working-interest percentage. The adjustment is made using the following formula.

$$\begin{array}{lcl} \text{Adjusted} & & \\ \text{Eligible} & = & \text{Eligible} \times \frac{10 \times \text{Net-Working-Interest Percentage}}{\text{Expense Percentage}} \\ \text{Expenses} & & \text{Expenses} \end{array}$$

$$A = E_1 \times \frac{10 \times \text{NWIP}}{\text{EP}}$$

If $\frac{10 \times \text{NWIP}}{\text{EP}}$ is greater than 1, it is deemed to be 1.

5.4.3 Straight-up

5.4.3.1 No penalty

In a situation in which the applicant incurs expenses when he has already acquired a working interest, eligible expenses are adjusted downwards if the expense percentage of the applicant is greater than his net-working-interest percentage. The adjustment to the eligible expenses is made using the following formula.

$$\begin{array}{lcl} \text{Adjusted} & & \\ \text{Eligible} & = & \text{Eligible} \times \frac{\text{Net-Working-Interest Percentage}}{\text{Expense Percentage}} \\ \text{Expenses} & & \text{Expenses} \end{array}$$

$$A = E_1 \times \frac{NWIP}{EP}$$

If $\frac{NWIP}{EP}$ is greater than 1, it is deemed to be 1.

Example 1: No Downward Adjustment of Eligible Expenses

An applicant has a net-working interest of 50 percent, and has incurred 50 percent of total eligible expenses of \$200,000--i.e., the applicant has incurred \$100,000 of eligible expenses.

$$\begin{aligned} A &= E_1 \times \frac{NWIP}{EP} \\ &= 100,000 \times \frac{50}{50} \\ &= 100,000 \end{aligned}$$

The appropriate PIP rate is applied to \$100,000 of adjusted eligible expenses to determine the amount of the PIP incentive.

Example 2: Some Downward Adjustment of Eligible Expenses

An applicant has a net-working interest of 25 percent, and has incurred 50 percent of total eligible expenses of \$200,000--i.e., the applicant has incurred \$100,000 of eligible expenses.

$$\begin{aligned} A &= E_1 \times \frac{NWIP}{EP} \\ &= 100,000 \times \frac{25}{50} \\ &= 50,000 \end{aligned}$$

The appropriate PIP rate is applied to \$50,000 of adjusted eligible expenses to determine the amount of the PIP incentive.

5.4.3.2 Penalty

(a) Provincial Lands

In a situation where an applicant has a working interest in respect of provincial lands, and where another owner of a working interest in the land does not incur his share of the expenses, the eligible expenses are adjusted downwards using the following formula.

$$\begin{array}{l} \text{Adjusted} \\ \text{Eligible} \\ \text{Expenses} \end{array} = \begin{array}{l} \text{Eligible} \\ \text{Expenses} \end{array} \times \frac{\text{Production-Penalty Percentage} - 100}{200}$$

$$A = E_2 \times \frac{PPP - 100}{200}$$

If $\frac{PPP - 100}{200}$ is greater than 1, it is deemed to be 1.

If the production penalty is 300 percent or more, there is no reduction of eligible expenses.

If the penalty is other than a production penalty, eligible expenses are adjusted to zero.

Example 1: No Downward Adjustment of Eligible Expenses

An applicant has a net-working interest of 50 percent on provincial lands in which he incurs 100 percent of total eligible expenses of \$200,000--\$100,000 of which is attributable to the applicant's own net-working interest and the other \$100,000 of which results from the other owner of a working interest not having incurred such expenses. The production-penalty percentage is 300.

$$\begin{aligned} A &= E_1 \times \frac{NWIP}{EP} + E_2 \times \frac{PPP - 100}{200} \\ &= 100,000 \times \frac{50}{50} + 100,000 \times \frac{300 - 100}{200} \\ &= 100,000 + 100,000 \\ &= 200,000 \end{aligned}$$

The appropriate PIP rate is applied to \$200,000 of adjusted eligible expenses to determine the amount of the PIP incentive.

Example 2: Some Downward Adjustment of Eligible Expenses

The situation is identical to that described above with the exception that the production penalty is 200 percent.

$$\begin{aligned}
 A &= E_1 \times \frac{NWIP}{EP} + E_2 \times \frac{PPP - 100}{200} \\
 &= 100,000 \times \frac{50}{50} + 100,000 \times \frac{200 - 100}{200} \\
 &= 100,000 + 50,000 \\
 &= 150,000
 \end{aligned}$$

The appropriate PIP rate is applied to \$150,000 of adjusted eligible expenses to determine the amount of the PIP incentive.

(b) Canada Lands

When an applicant who owns a working interest in respect of certain lands in Canada Lands incurs eligible expenses in respect of a well that are not borne by, but which are attributable to, another working-interest owner, the eligible expenses are adjusted by the following formulae:

(i) in the case of a production penalty:

$$\begin{array}{l} \text{Adjusted} \\ \text{Eligible} \\ \text{Expenses} \end{array} = \begin{array}{l} \text{Eligible} \\ \text{Expenses} \end{array} \times \frac{\text{Production-Penalty Percentage} - 100}{400}$$

$$A = E_2 \times \frac{PPP - 100}{400}$$

If $\frac{PPP - 100}{400}$ is greater than 1, it is deemed to be 1.

If the production penalty is larger than 500 percent, there is no reduction of eligible expenses.

(ii) in the case of a net-working-interest penalty:

$$\begin{array}{l} \text{Adjusted} \\ \text{Eligible} \\ \text{Expenses} \end{array} = \begin{array}{l} \text{Eligible} \\ \text{Expenses} \end{array} \times \frac{\text{Penalty-Net-Working-Interest Percentage}}{\text{Land-Penalty Formula}}$$

$$A = E_2 \times \frac{PNWIP}{LPF}$$

$$LPF = 10\% \times TNWIP \times \frac{E_2}{TPE}$$

If $\frac{PNWIP}{LPF}$ is greater than 1, it is deemed to be 1.

(iii) in any other case, to zero:

Eligible expenses may be adjusted by the production-penalty formula only when the eligible expenses are incurred pursuant to a written agreement entered into on or before October 28, 1980 that provides for a production penalty.

Example: Some Downward Adjustment of Eligible Expenses

An applicant has a net-working interest of 50 percent on certain land in Canada Lands in which he incurs 100 percent of total eligible expenses of \$2 million--\$1 million of which is attributable to the applicant's net-working interest, and the other \$1 million of which results from the other owner of a working interest not having incurred the expenses. The net-working-interest penalty is eight percent of the other owner's net-working-interest percentage of 50 percent--i.e., the applicant's working interest increases by four percent.

$$\begin{aligned} LPF &= 10\% \times TNWIP \times \frac{E_2}{TPE} \\ &= 10\% \times 50\% \times \frac{1,000,000}{1,000,000} \\ &= 5\% \end{aligned}$$

$$\begin{aligned} A &= E_1 \times \frac{NWIP}{EP} + E_2 \times \frac{PNWIP}{LPF} \\ &= 1,000,000 \times \frac{50}{50} + 1,000,000 \times \frac{4}{5} \\ &= 1,000,000 + 800,000 \\ &= 1,800,000 \end{aligned}$$

The appropriate PIP rate is applied to \$1,800,000 of adjusted eligible expenses to determine the amount of the PIP incentive.

5.5 Transfer Through the Size of the Block of Land

To obtain full PIP incentives on all eligible expenses in a farm-in situation, the farmee applicant must earn a net-working-interest land area equal in size to a minimum land block. To obtain full PIP incentives on all eligible expenses in a straight-up situation, the applicant must hold a working interest in a net-working-interest land area equal in size to a minimum land block. The minimum land blocks vary from area to area both on Canada Lands and on provincial lands. These minimum land blocks are defined as follows:

5.5.1 Exploration

5.5.1.1 Canada Lands

When eligible exploration expenses are incurred on Canada Lands, a minimum land block is

- (a) 4,000 hectares (9,884 acres) in the Liard area;
- (b) 8,000 hectares (19,769 acres) in the Mackenzie Valley and Yukon Territory area; and
- (c) 18,000 hectares (44,480 acres) in all other areas.

The net-working-interest land area claimed to satisfy the minimum land block requirement when the applicant's working interest is earned by incurring agreed expenses, consists of an area of land, approximately "centered" on the well, composed of complete survey sections, including that in which the well is drilled, and forming, to the greatest extent possible, a square block. (See Figure 1.)

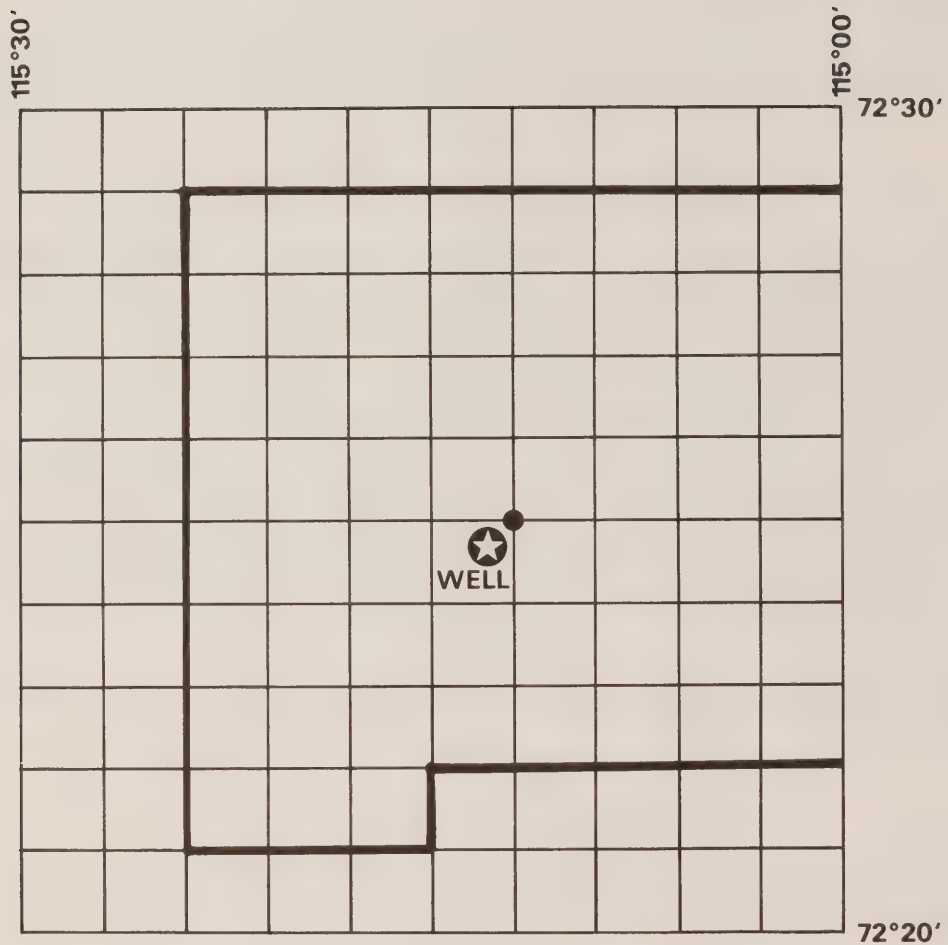
The centering of the net-working-interest land area on the well is determined by reference to the nearest point at which survey section lines intersect.

5.5.1.2 Provincial Lands

When eligible exploration expenses are incurred on provincial lands, a minimum land block is

- (a) 130 hectares (320 acres) in the Lloydminster area;
- (b) 259 hectares (640 acres) in the Plains area;
- (c) 518 hectares (1,280 acres) in the Northern area;
- (d) 1,036 hectares (2,560 acres) in the Foothills and Western area;
- (e) 18,000 hectares (44,480 acres) in the Central Canada area;
- (f) 81 hectares (200 acres) in the Southwestern Ontario area;
- (g) 259 hectares (640 acres) in the Eastern area and under Lake Erie;
- (h) 18,000 hectares (44,480 acres) in the Bay of Fundy and St. Lawrence area.

Figure 1. Centering of Well on Minimum Land Block in Canada Lands.



1 SECTION = 772 ACRES

59 SECTIONS = 45,548 ACRES 'MINIMUM LAND BLOCK'

5.5.2 Development

When eligible development expenses are incurred on provincial lands, a minimum land block is one drilling spacing unit as determined by the relevant provincial legislation. In provinces which do not have legislation defining a spacing unit, a minimum land block is 65 hectares.

When eligible development expenses are incurred on Canada Lands, a minimum land block is one section as defined in the Canada Oil and Gas Land Regulations.

5.5.3 Adjustment Formula

In a situation in which an applicant earns a net-working interest in an area of land which consists of less than a minimum land block, the amount of expenses eligible for PIP incentives is adjusted downwards using the following formula.

$$\begin{array}{l} \text{Adjusted} \\ \text{Eligible} \\ \text{Expenses} \end{array} = \begin{array}{l} \text{Eligible} \\ \text{Expenses} \end{array} \times \frac{\text{Net-Working-Interest Land Area}}{\text{Minimum Land Block}}$$

$$A = E_1 \times \frac{NWILA}{MLB}$$

An applicant must use a different area of land in respect of each well to satisfy the net-working-interest land area adjustment in farm-in situations. This net-working-interest land area must include the well-site in relation to which the expenses are incurred.

Example 1: No Downward Adjustment of Eligible Expenses

An applicant earns a net-working interest of 50 percent in 259 hectares in the Plains area by incurring 100 percent of total eligible expenses of \$200,000.

$$\begin{aligned} A &= E_1 \times \frac{NWILA}{MLB} \\ &= 200,000 \times \frac{259}{259} \\ &= 200,000 \end{aligned}$$

The appropriate PIP rate is applied to \$200,000 of adjusted eligible expenses to determine the amount of the PIP incentive.

Example 2: Some Downward Adjustment of Eligible Expenses

An applicant earns a net-working interest of 50 percent in 129.5 hectares in the Plains area by incurring 100 percent of total eligible expenses of \$200,000.

$$\begin{aligned} A &= E_1 \times \frac{NWILA}{MLB} \\ &= 200,000 \times \frac{129.5}{259} \\ &= 100,000 \end{aligned}$$

The appropriate PIP rate is applied to \$100,000 of adjusted eligible expenses to determine the amount of the PIP incentive.

5.6 Working-Interest and Minimum-Land-Block Adjustments

Adjusting eligible expenses for working interest, penalties, and land area has each been discussed in isolation. In reality, an applicant has to meet both the working-interest and land-area rules simultaneously, unless the adjustment formulae do not apply at all.

Farm-in

$$A = E_1 \times \frac{2 \times NWIP}{EP} \times \frac{NWILA}{MLB}$$

Delineation

$$A = E_1 \times \frac{10 \times NWIP}{EP} \times \frac{NWILA}{MLB}$$

Straight-up

$$A = E_1 \times \frac{NWIP}{EP} \times \frac{NWILA}{MLB}$$

Straight-up With Working-Interest Penalty

$$A = E_1 \times \frac{NWIP}{EP} \times \frac{NWILA}{MLB} + E_2 \times \frac{PNWIP}{LPF} \times \frac{PLA}{MLB}$$

Example 1: No Downward Adjustment of Eligible Expenses

An applicant earns a net-working interest of 50 percent by incurring 100 percent of the cost of one well in 259 hectares in the Plains area. Total eligible expenses are \$200,000.

$$\begin{aligned} A &= E_1 \times \frac{2 \times \text{NWIP}}{\text{EP}} \times \frac{\text{NWILA}}{\text{MLB}} \\ &= 200,000 \times \frac{100}{100} \times \frac{259}{259} \\ &= 200,000 \end{aligned}$$

The appropriate PIP rate is applied to \$200,000 of adjusted eligible expenses to determine the amount of the PIP incentive.

Example 2: Some Downward Adjustment of Eligible Expenses

An applicant earns a net-working interest of 40 percent by incurring 100 percent of the total cost of one well in 777 hectares in the Foothills and Western area. Total eligible expenses are \$500,000.

$$\begin{aligned} A &= E_1 \times \frac{2 \times \text{NWIP}}{\text{EP}} \times \frac{\text{NWILA}}{\text{MLB}} \\ &= 500,000 \times \frac{80}{100} \times \frac{777}{1036} \\ &= 500,000 \times 0.8 \times 0.75 \\ &= 300,000 \end{aligned}$$

The appropriate PIP rate is applied to \$300,000 of adjusted eligible expenses to determine the amount of the PIP incentive.

5.7 Compensation for More than Minimum Working Interest or Minimum Land Block on Provincial Lands

Situations arise where the net-working interest to be earned is below the minimum, while the net-working-interest land area is above the minimum. Likewise, situations arise where the net-working interest to be earned is above the minimum, while the net-working-interest land area is below the minimum. It has been decided that on provincial lands, in earning situations, a net-working-interest land area of up to one and one-half the minimum land block may be used to compensate a working interest that is below the required interest to avoid adjustment, and that up to one and one-half the working interest required to avoid such adjustment may

be used to compensate a net-working-interest land area that is below the minimum. This rule does not apply to Canada Lands. This can be expressed as follows:

$$A = E_1 \times \frac{2 \times \text{NWIP}}{\text{EP}} \times \frac{\text{NWILA}}{\text{MLB}}$$

On provincial lands, if either $\frac{2 \times \text{NWIP}}{\text{EP}}$ or $\frac{\text{NWILA}}{\text{MLB}}$ is greater than 1.5, it is deemed to be 1.5.

On Canada Lands, if $\frac{2 \times \text{NWIP}}{\text{EP}}$ or $\frac{\text{NWILA}}{\text{MLB}}$ is greater than 1, it is deemed to be 1.

On both Canada Lands and provincial lands, if the product of $\frac{2 \times \text{NWIP}}{\text{EP}}$ and $\frac{\text{NWILA}}{\text{MLB}}$ is greater than 1, it is deemed to be 1.

Example:

An applicant earns a net-working interest of 33-1/3 percent by incurring 100 percent of the costs of one well in 388.5 hectares in the Plains area. Eligible expenses incurred by the applicant are \$300,000.

$$\begin{aligned} A &= E_1 \times \frac{2 \times \text{NWIP}}{\text{EP}} \times \frac{\text{NWILA}}{\text{MLB}} \\ &= 300,000 \times \frac{2}{3} \times \frac{388.5}{259} \\ &= 300,000 \times \frac{2}{3} \times 1.5 \\ &= 300,000 \end{aligned}$$

The appropriate PIP rate is applied to \$300,000 of adjusted eligible expenses to determine the amount of the PIP incentive.

5.8 Situations Not Requiring Use of Adjustment Formulae

Depending on the circumstances set forth in 5.8.1 to 5.8.2.2, the applicant may apply for PIP incentives on his eligible expenses rather than on his adjusted eligible expenses, when:

- (a) subject to 5.4.3.2(b), the expense is incurred pursuant to a written agreement entered into on or before October 28, 1980 for expenses incurred on or before December 31, 1985;

- (b) in the case of provincial lands, all other working-interest owners in the prospect (all contiguous land in which the applicant owns a working interest) to which the expense pertains have a COR of 50 percent or more and are Canadian controlled, and the working interest of the applicant is not subject directly or indirectly to a gross or net interest, the beneficial owner of which is foreign controlled or has a COR of less than 50 percent;
- (c) in the case of Canada Lands, all other working-interest owners in the prospect to which the expense pertains have a COR at the same level or higher than that of the applicant and are Canadian controlled, and the working interest of the applicant is not subject directly or indirectly to a gross or net interest, the beneficial owner of which is foreign controlled or has a lower-level COR than the applicant;
- (d) in the case of a production penalty on provincial lands, all other working-interest owners in the prospect to which the expense pertains that have not incurred expenses have a COR of 50 percent or more and are Canadian controlled, and the working interest of the applicant is not subject directly or indirectly to a gross or net interest, the beneficial owner of which is not dealing at arm's length with a non-participating party and is either foreign controlled or has a COR of less than 50 percent;
- (e) in the case of a production penalty on Canada Lands, all other working-interest owners in the prospect to which the expense pertains that have not incurred expenses have a COR at the same level or higher than that of the applicant and are Canadian controlled, and the working interest of the applicant is not subject directly or indirectly to a gross or net interest, the beneficial owner of which is not dealing at arm's length with a non-participating party and is either foreign controlled or has a lower-level COR than the applicant;
- (f) in the case of a net-working-interest penalty on Canada Lands, all other working-interest owners in the prospect to which the expense pertains that have not incurred expenses have a COR at the same level or higher than that of the applicant and are Canadian controlled, and the working interest of the non-participating party is not subject directly or indirectly to a gross or net interest, the beneficial owner of which is not dealing at arm's length with a non-participating party and is either foreign controlled or has a lower-level COR than the applicant; or
- (g) geophysical, geological or geochemical expenses are incurred.

Paragraph (a) does not apply to an expense incurred pursuant to an agreement where any material provision affecting the benefits accruing to, or the obligations assumed by, the applicant has been changed significantly since October 28, 1980.

The exclusion from the adjustment rules outlined in paragraph (a) do not affect the basic program requirement that an applicant establish he has, or is entitled to earn, a working interest in the lands in respect of which the expenses are incurred. The Minister has relieving discretion in the application of this rule. A working interest is not required if paragraphs (b), (c) or (g) apply.

5.8.1 Farm-in and Straight-up

The applicant may apply for PIP incentives on his eligible expenses rather than his adjusted eligible expenses when paragraphs (a), (b) or (c) apply.

5.8.2 Straight-up With Penalty

5.8.2.1 Provincial Lands

The applicant may apply for PIP incentives on his eligible expenses rather than his adjusted eligible expenses when, with regard to "E₁", paragraphs (a) or (b) apply and, with regard to "E₂", paragraph (d) applies.

5.8.2.2 Canada Lands

The applicant may apply for PIP incentives on his eligible expenses, rather than his adjusted eligible expenses when, with regard to "E₁", paragraphs (a) or (c) apply and, with regard to "E₂", paragraphs (e) or (f) apply.

5.9 Amount of Work in Area of Land

The basic farm-in rule is that an applicant must earn a minimum working interest in a minimum land block by incurring expenses related to a single well. When more than this minimum amount of work is required to earn an interest, expenses related to the excess work requirements are only eligible for incentives on the basis that the working interest had already been earned.

Example:

An applicant earns a net-working interest of 50 percent in 259 hectares in the Plains area by incurring 100 percent of the cost of two wells. Total eligible expenses are \$400,000 in the first well and \$200,000 in the second well. The farm-in formula applies to the first well and the straight-up formula applies to the second well.

First Well

$$\begin{aligned} A &= E_1 \times \frac{2 \times \text{NWIP}}{\text{EP}} \times \frac{\text{NWILA}}{\text{MLB}} \\ &= 400,000 \times \frac{2 \times 50}{100} \times \frac{259}{259} \\ &= 400,000 \end{aligned}$$

Second Well

$$\begin{aligned} A &= E_1 \times \frac{\text{NWIP}}{\text{EP}} \times \frac{\text{NWILA}}{\text{MLB}} \\ &= 200,000 \times \frac{50}{100} \times \frac{259}{259} \\ &= 100,000 \end{aligned}$$

The appropriate PIP rate is applied to \$500,000 of adjusted eligible expenses to determine the amount of the PIP incentive.

5.10 Sharing of Non-Eligible Expenses

Benefits of the program could be transferred indirectly to low-COR entities depending on the way in which expenses which are not eligible for PIP incentives are shared. Special rules governing the sharing of these non-eligible expenses have therefore been developed to reduce this possibility.

5.10.1 Land Acquisition and Maintenance Costs

Any expense incurred by the applicant in an earning situation which reimburses the farmor for land acquisition costs or land maintenance costs (i.e., payments required to maintain the lease) incurred by the farmor prior to entering into the farm-out agreement, will be subtracted dollar for dollar from the applicant's eligible expenses at the time of applying for PIP incentives.

5.10.2 Equipping Costs

Equipping costs include the costs of pumps, flow lines, production tankage and, in the case of a gas well, heaters, compressors and dehydrators.

5.10.2.1 Provincial Lands

When the eligible expenses of a well are incurred by the applicant to earn a working interest, the applicant's share of equipping costs in respect of the well may be greater than his net-working-interest percentage related to the eligible expenses, where that net-working-interest percentage is determined by the deduction of only those net interests and gross interests beneficially owned by any other working-interest owner in the lands or any person not dealing at arm's length with such a person.

In any other case, no incentives are paid on the eligible expenses in respect of a well if the applicant's share of equipping costs is larger than his net-working-interest percentage related to the eligible expenses as calculated above.

5.10.2.2 Canada Lands

No incentives are paid on the eligible expenses in respect of a well if the applicant's share of equipping costs is larger than his net-working-interest percentage related to the eligible expenses as calculated above.

5.10.3 Post-Equipping Costs

Post-equipping costs are expenditures incurred in the recovery and disposition of oil or gas obtained from an oil or gas well, and include operating expenditures in respect of the well and expenditures in respect of the transportation, refining, processing and sale of the oil and gas obtained therefrom, but do not include eligible costs or expenses, land acquisition costs, equipping costs or overheads.

No incentives are paid on the eligible expenses if the applicant's share of post-equipping costs related to a well, or the production therefrom, is greater than his net-working-interest percentage related to the eligible expenses as calculated above.

These rules need not be applied when:

- (a) the expense is incurred pursuant to a written agreement entered into prior to publication of this paper, no material provision of which has been changed significantly since that date;
- (b) in the case of provincial lands, all entities that beneficially own an interest in the prospect to which the expense pertains have a COR of 50 percent or more and are Canadian controlled; or
- (c) in the case of Canada Lands, all entities that beneficially own an interest in the prospect to which the expense pertains have a COR at the same level or higher than the applicant and are Canadian controlled.

6. ADJUSTED ELIGIBLE COSTS

The applicant may apply for PIP incentives on all of his eligible costs in respect of an oil sands facility or a heavy oil upgrading facility if his operating-interest percentage in the assets is the same as, or larger than, his cost percentage in those assets. Any obligation to dispose of all or part of an operating-interest percentage which is in existence when the expenditures are incurred is deemed to have been carried out when calculating the operating-interest percentage. If the operating-interest percentage is smaller than the cost percentage, the following adjustment formula is applied.

$$A = C \times \frac{OIP}{CP}$$

The applicant may apply for PIP incentives on all of his eligible costs in respect of a tertiary oil recovery project if his operating-interest percentage in the assets and his net-working-interest percentage in the oil in the ground to which the project pertains are the same as, or larger than, his cost percentage in the assets.

$$A = C \times \frac{IP}{CP}$$

where IP equals the lesser of NWIP and OIP.

The applicant may apply for PIP incentives on his eligible costs, rather than his adjusted eligible costs, when:

- (a) the expense is incurred pursuant to a written agreement entered into on or before October 28, 1980 for expenses incurred on or before December 31, 1985; or
- (b) all entities that beneficially own, or are entitled to acquire an operating interest in the oil sands facility, heavy oil upgrader or tertiary oil recovery project have a COR of 50 percent or more and are Canadian controlled; and
- (c) in the case of a tertiary oil recovery project, all other working-interest owners in the lands to which the project pertains have a COR of 50 percent or more and are Canadian controlled, and the working interest of the applicant is not subject directly or indirectly to a gross or net interest, the beneficial owner of which is foreign controlled or has a COR of less than 50 percent.

Subparagraph (a) does not apply to an expense incurred pursuant to an agreement where any material provision affecting the benefits accruing to, or the obligations assumed by, the applicant has been changed significantly since October 28, 1980.

7. IMPROPER OR ARTIFICIAL TRANSACTIONS

Where the Minister is of the opinion that an applicant or recipient has done anything to increase improperly, unduly or artificially the amount of an incentive, he may refuse to pay the incentive or may reduce it to such an extent as he considers appropriate.

8. PIP APPLICATION PROCEDURE AND GENERAL INFORMATION

8.1 Steps in Applying to the Petroleum Incentives Program

8.1.1 Obtain COR Certificate

With the exception of the 25-percent Crown Share Incentive and subject to the transitional period described earlier, all applicants for PIP incentives must have a valid COR certificate issued by the PMA, which shows that they are Canadian controlled and that they had a COR of 50 percent or more at the time of incurring the costs or expenses. These certificates will be available from the PMA when the necessary legislation has been passed by Parliament.

Petroleum Monitoring Agency
Energy, Mines and Resources Canada
Ottawa, Ontario
K1A 0E4
Phone: (613) 996-4444

8.1.2 Obtain Application Forms from PIP

Application forms can be obtained from the

Petroleum Incentives Program
Energy, Mines and Resources Canada
Ottawa, Ontario
K1A 0E4
Phone: (613) 996-2611

or

Petroleum Incentives Program
Energy, Mines and Resources Canada
P.O. Box 2907, Station M
Calgary, Alberta
T2P 3L7
Phone: (403) 231-5005

These forms will be available after the legislation establishing the program has been passed.

8.1.3 Complete and File PIP Application Forms

The third step is to complete the application forms and send them, together with all the required supporting documents, to the

Petroleum Incentives Program
Energy, Mines and Resources Canada
Ottawa, Ontario
K1A OE4

8.2 Frequency of Applications

Applications may be made as frequently as quarterly, or on an annual basis. When application is made other than on an annual basis, an annual summary is required. There are no holdbacks on quarterly payments.

8.3 Time Limits

An application must be filed by the first anniversary of the end of the applicant's fiscal year in which the expenses were incurred in order for those expenses to be considered as eligible expenses upon which PIP incentives will be paid.

8.4 Recoveries

The Petroleum Incentives Board has the authority to recover overpaid amounts plus accrued interest directly from an applicant or to deduct such amounts from future claims. Recoveries may result from adjustments reported by an applicant or errors identified by audit.

8.5 Forecasts

Persons who have made an application in a given year are required to submit a forecast of eligible costs and expenses for the following calendar year by January 31 of that year, if expected PIP incentives will be \$1 million or more. The forecast is to be of the totals of the applicant's eligible exploration expenses, eligible development expenses and eligible asset costs, to be further subdivided according to whether they relate to Canada Lands or provincial lands.

First-time applicants are also required to submit a forecast at the time of their first application covering the balance of the calendar year, if expected PIP incentives will be \$1 million or more. The same rule applies to applicants who have filed applications, but who are not subject to the January 31 reporting requirement, by virtue of not having submitted an application in the immediately preceding year. These requirements do not apply in 1981, with the result that no forecasts for 1981 are required under the program.

Any applicant who enters into a deal in which the costs or expenses could foreseeably result in \$25 million or more of PIP incentives in the future is required to notify the Petroleum Incentives Board prior to incurring any of those costs or expenses.

8.6 Audit

The Petroleum Incentives Board has the right to audit applications either before or after paying incentives. Additional documents may also be requested at any time and records must be kept by applicants to verify the information submitted.

Except with permission of the Board, documents are not to be disposed of before the expiry of six years from the day the Board receives the application to which the documents relate.

8.7 Enforcement and Penalties

Appropriate penalties exist for providing false or misleading information or for failure to disclose material facts.

8.8 Advance Rulings

Once legislation has been passed, the Board may provide advance rulings on any matter to be determined or approved by the Board. Advance rulings will be issued only in respect of proposed transactions which are seriously contemplated and which are not of a hypothetical nature.

Appendix

This Appendix enumerates some of the more significant differences between the policies outlined in the December 19, 1980 publication, "Petroleum Incentives Program, The Basic Rules--A Framework", and the policies outlined in this document.

1. The rule that quarterly payments would be subject to a 20-percent holdback provision has been dropped.
2. The rule that forecasts for 1981 would be required from applicants who expect more than \$75 million of PIP incentives in 1981 has been dropped.
3. Annual forecasts for 1982 and subsequent years are now required by January 31 of the year in question, not October 15 of the previous year.
4. Application for PIP incentives must be made within one year of the end of the calendar year in which the expense was incurred, rather than within three years.
5. The PIP rate table has been changed and now has four levels rather than three.
6. The rule that a working interest is required in order to qualify for incentives has been modified.
7. The rule that when eligible expenditures are reduced because of the application of minimum rules for working interest and acreage, each reduction would be applied separately to the eligible expenditures has been dropped. The rules are now applied concurrently, rather than separately.
8. Any applicant who enters into a deal in which the costs or expenses could foreseeably result in \$25 million or more of PIP incentives in the future is required to notify the Petroleum Incentives Board prior to incurring any of those costs or expenses.
9. The section on eligibility of geophysical expenditures has been expanded (Section 4.3).

In addition to these policy changes, new concepts have been introduced.

- (a) Grace periods (Section 2.2).
- (b) Transitional COR determination (Section 2.3).
- (c) New minimum-land-block areas (Section 5.6).
- (d) Compensation for more than minimum-land-block size (Section 5.7).
- (e) Grandfathering of agreements entered into prior to October 28, 1980 (Section 5.8).

MINIMUM LAND BLOCK AREAS

CANADA LANDS

1. Mackenzie Valley and Yukon Territory Area

2. Liard Area

3. All other Areas

PROVINCIAL LANDS

4. Northern Area

5. Central Canada Area

6. Southwestern Ontario Area

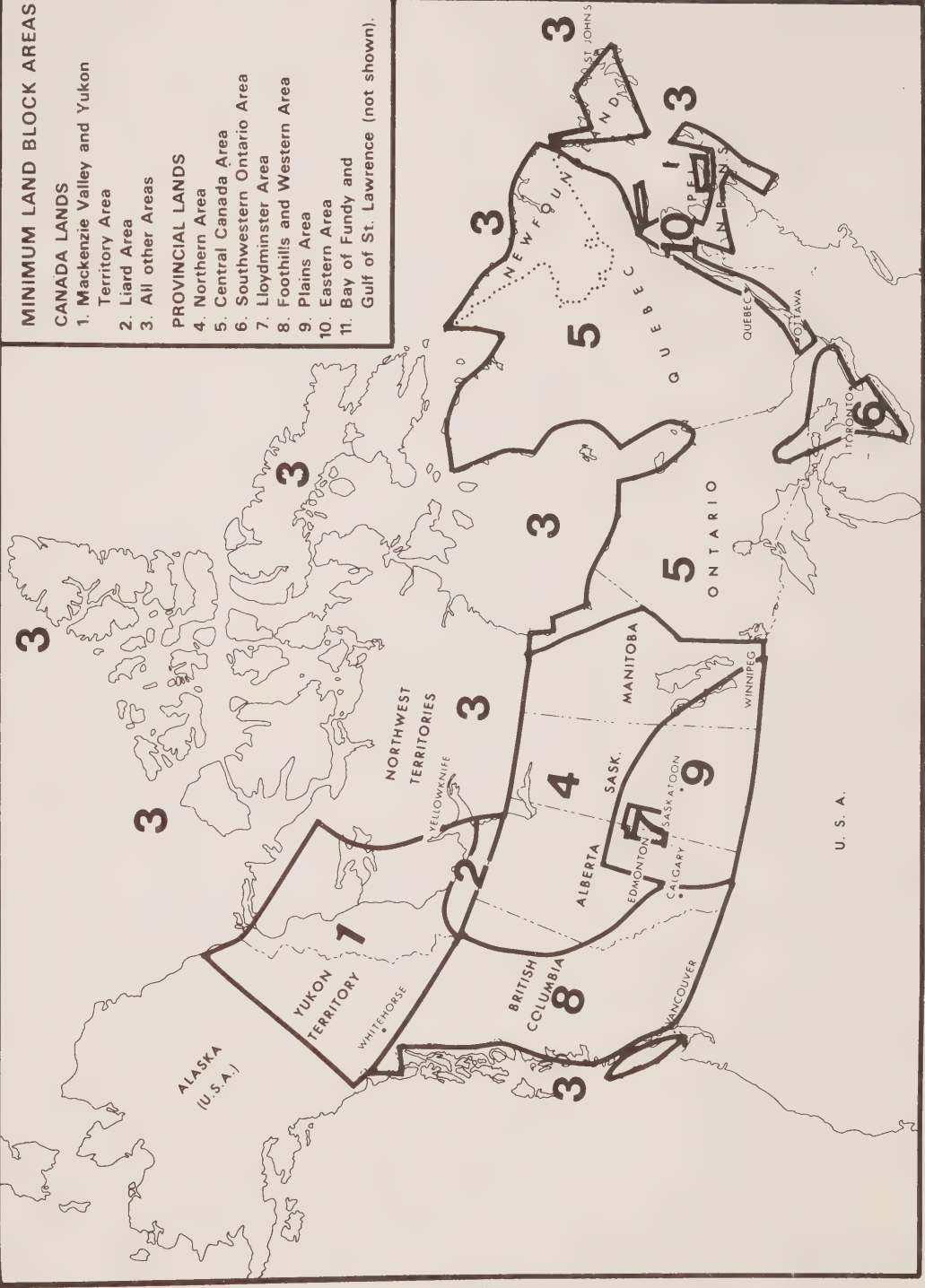
7. Lloydminster Area

8. Foothills and Western Area

9. Plains Area

10. Eastern Area

11. Bay of Fundy and Gulf of St. Lawrence (not shown).



BACKGROUNDER

Mr. Lalonde announced that the document released today contains several modifications to the rules proposed in the December 19, 1980 paper, "The Petroleum Incentives Program — The Basic Rules — A Framework". The modified program contains the following main elements:

1. The Petroleum Incentives Program (PIP) is designed to create an entitlement for qualified applicants to receive PIP incentives. The rules that govern the amount of an incentive are certain — PIP is not a discretionary program. The amount of Ministerial or other discretion is limited and is essentially relieving discretion.
2. Applicants who incur eligible expenses on oil and gas exploration and development in Canada, or who incur eligible costs in the purchase of certain assets, may obtain incentive grants by applying to the Petroleum Incentives Board (PIB).
3. PIP incentives will be a percentage of eligible costs or expenses. The exact percentage will depend on:
 - i) the Canadian Ownership Rate (COR) of the applicant,
 - ii) the Canadian control status of the applicant,
 - iii) the location of the expenditure (i.e., Canada Lands or provincial lands),
 - iv) the type of expenditure (i.e., exploration, development and eligible assets),
 - v) the year in which the expenditures are incurred.
4. Individuals, corporations, partnerships and trustees, administrators or other legal representatives of trust property may apply for PIP incentives. With the exception noted below, persons who are tax-exempt under Section 149 of the Income Tax Act at the time the eligible expenses are incurred will not be eligible for PIP incentives for such expenses, other than the 25 per cent Crown Share Incentive on Canada Lands.



5. Corporations which are controlled directly or indirectly by the Crown will not be eligible applicants unless they have given a satisfactory undertaking that they do not intend to become tax exempt. Crown corporations which are listed in Schedule D of the Financial Administration Act will be eligible applicants.
6. A joint exploration corporation within the meaning of the Income Tax Act will be treated in the same manner as any other corporation for the purpose of PIP incentives. In other words, the joint exploration corporation will be the applicant and will be entitled to incentives in its own right.
7. As a general rule, partnerships will be the applicant for PIP incentives, not the individual partners. The Minister will have discretion to allow individual partners within small partnerships to be eligible applicants.
8. A grace period will exist to provide a reasonable time during which corporations can increase their COR level back to its previous level if the decrease is caused by factors beyond the control of the corporation.
9. Once the COR and PIP legislation is enacted, the Minister will have the authority during a transitional period to accept the calculation submitted by the applicant to the Petroleum Monitoring Agency as evidence of an applicant's COR level and Canadian control status.
10. For the purpose of the Petroleum Incentives Program, eligible expenditures will fall into three categories:
 - Eligible Exploration Expenses,
 - Eligible Development Expenses, and
 - Eligible Asset Costs.

11. In general, expenses will be eligible exploration expenses and eligible development expenses if they fall within the definitions of Canadian exploration or Canadian development expense in the Income Tax Act. However, PIP incentives will not be paid on any expense which constitutes a "Canadian exploration and development overhead expense" as defined in the Income Tax Regulations.
12. In general, eligible asset costs will include capital costs incurred in the construction or improvement of an oil sands facility, a heavy oil upgrader, or a tertiary oil recovery project located in Canada if the facility or project has been approved by the Minister of Energy, Mines and Resources and if the assets are eligible to earn depletion under the Income Tax Act.
13. Any assistance or benefit received from a government, municipality or other public authority for an eligible cost or expense within 5 years of incurring the eligible cost or expense will reduce the amount of the cost or expense eligible for PIP incentives.
14. For certain large projects involving \$100 million or more of PIP incentives in a year, the prior approval of the Minister will be required. In general, approval of large projects will be given when the foreign-controlled entities agree to a program to raise their Canadian ownership to 50 per cent or more and agree to become Canadian-controlled.
15. A major challenge associated with the design of PIP has been the recognition that the benefits conferred by PIP on Canadians could, in a variety of ways, be transferred to non-Canadians. This concern has been examined in depth and it has been concluded that the normal workings of the marketplace would not discourage this tendency to a sufficient degree. This has led to the conclusion that rules are required to keep such transfers to a minimum.

16. First, any expenses incurred by the applicant as earning expenses for the farmor's land acquisition or land maintenance costs will be deducted dollar for dollar from the applicant's eligible expenses.
17. Second, the eligible expenses will be adjusted by the application of the adjustment factors. These adjustment factors govern the size of the working interest to be earned relative to expenses incurred in a farm-in situation, the size of the working interest relative to expenses in situations where the working interest has already been earned, and the area of land in which the working interest will be earned.
18. It should be noted, however, that these adjustments do not have to be applied in all situations, and in the situations where they do not apply, the applicant may apply for PIP incentives without adjustment of his eligible expenses. For example, if:
 - i) the expense is incurred pursuant to a written agreement entered into on or before October 28, 1980, or
 - ii) in the case of provincial lands, all other working interest owners in the land to which the expense pertains have a COR of 50 per cent or more and are Canadian controlled, or
 - iii) in the case of Canada Lands, all other working interest owners in the land to which the expense pertains have a COR at the same level or higher and are Canadian controlled,the adjustment rules need not be applied, and the applicant may apply for PIP incentives on his eligible expenses, rather than his adjusted eligible expenses.
19. Furthermore, the Minister will have relieving discretion in the application of the adjustment factors. This flows from the recognition that the adjustment formulae are general rules which may work a hardship in individual cases.

Table 1. Transition Period for Phasing-in Incentive Payments

	<u>COR Level of Applicants</u>			
	Level 1*	Level 2	Level 3	Level 4
	%	%	%	%
1981	less than 50	50 or more	60 or more	65 or more
1982	50	50	61	67
1983	50	50	62	69
1984	50	50	63	71
1985	50	50	64	73
1986 and later	50	50	65	75

* Level 1 refers to applicants who have CORs of less than 50 per cent or who are not Canadian controlled.

Table 2.

Percentage Levels of Incentive Payments for Oil and Gas
Exploration, Development and Assets Costs.

	<u>Provincial Lands</u>				<u>Canada Lands</u>			
	Level				Level			
	1	2	3	4	1	2	3	4
	%	%	%	%	%	%	%	%
<u>Exploration</u>								
1981	nil	nil	25	35	25*	35**	65**	80**
1982	nil	10	25	35	25	45	65	80
1983	nil	10	25	35	25	45	65	80
1984	nil	15	25	35	25	50	65	80
1985	nil	15	25	35	25	50	65	80
1986	nil	15	25	35	25	50	65	80
<u>Development</u>								
1981	nil	nil	15	20	nil	nil	15	20
1982	nil	10	15	20	nil	10	15	20
1983	nil	10	15	20	nil	10	15	20
1984	nil	10	15	20	nil	10	15	20
1985	nil	10	15	20	nil	10	15	20
1986	nil	10	15	20	nil	10	15	20
<u>Assets Costs</u>								
1981	nil	nil	15	20	nil	nil	15	20
1982	nil	10	15	20	nil	10	15	20
1983	nil	10	15	20	nil	10	15	20
1984	nil	10	15	20	nil	10	15	20
1985	nil	10	15	20	nil	10	15	20
1986	nil	10	15	20	nil	10	15	20

* The 25 per cent Crown Share Incentive

** Includes the 25 per cent Crown Share Incentive available to all investors.

